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In the

Supreme Court of the United States

October Term, 1972

No. 73-32

FINANCIAL INDUSTRIAL FUND, INC.,
Petitioner,

v.

McDONNELL DOUGLAS CORPORATION,
Respondent.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY IN SUPPORT OF CERTIORARI

Leland E. Modesitt
1900 Security Life Building
Denver, Colorado 80202
COUNSEL OF RECORD FOR PETITIONER

OF COUNSEL:

Richard H. Shaw
1500 United Bank Center
Denver, Colorado 80202

John J. King, Jr.
Gorsuch, Kirgis, Campbell, Walker and Grover
1900 Security Life Building
Denver, Colorado 80202

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The assertions of respondent in the hope of escaping review serve to emphasize rather than dilute the compelling importance of the issues presented. These issues have serious implications far beyond the confines of this single case, as will be apparent upon considering:

I. *Where an issuer corporation has published optimistic earnings reports and predictions and knows that others have published such reports, it has a duty to public investors to disclose adverse facts and developments as soon as they become material.*

As its first and primary reason why review by this Court should be denied, Respondent avers that this case is of too little

importance to merit the attention of this Court—that it is an inconsequential dispute between petitioner and respondent circumscribed by facts which occurred in a limited time period. On the contrary, what is at stake in this case is the fairness, honesty, and integrity of national security markets.

The decisions of this Court cited in the Petition as well as many lower court decisions[1] clearly enunciate the duty of an issuer corporation to make full and complete disclosure of material facts affecting the value of its stock traded on national markets and otherwise. The cardinal legal question of national importance here presented is the extent to which this duty to public investors lies within the discretion and judgment of issuer corporations.

Respondent argues that with respect to the duty of full and complete disclosure to the public, the courts must exercise restraint and defer to "business judgment" and non-hindsight policies; and that all three considerations were accommodated by the Second Circuit in *Securities and Exchange Commission v. Texas Gulf Sulphur Co.,* 401 F.2d 833 (2d Cir. 1968), cert. denied, *sub. nom. Coates v. SEC,* 394 U.S. 976 (1969), and by the Tenth Circuit in this case and in *Mitchell v. Texas Gulf Sulphur Co.,* 446 F.2d 90 (10th Cir. 1971), cert. denied, 404 U.S. 1004 (1971). Respondent's argument is fallacious in that the standards applied in the *TGS* cases were not applied below. In the *TGS* cases, the market price of the stock was depressed and public investors sold at a loss

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[1]See, e.g., *Kohler v. Kohler Co.,* 319 F.2d 634, 637-38 (7th Cir. 1963); *Brennan v. Midwestern United Life Ins. Co.,* 417 F.2d 147 (7th Cir. 1969); *Green v. Jonhop,* 358 F.Supp. 413 (D. Ore. 1973); *Kahan v. Rosenstiel* 424 F.2d 161, 173 (3d Cir. 1970), where the Court stated: "***The Act was designed to eliminate deceptive and unfair practices in security trading and to protect the public from inaccurate, incomplete, and misleading information. The thrust of the Act and the decisions interpreting it is to give the investing public the opportunity to make knowing and intelligent decisions regarding the purchase or sale of securities." (424 F.2d at 173)

as the result of a gloomy and pessimistic press release on April 12 to the effect that rumors which had been widely reported in the press regarding the company's mineral discovery in the area of Timmons, Ontario, were exaggerated and without factual basis. On April 16, TGS issued a release proclaiming a major discovery supported by assays of drilling cores and other detailed factual data. It was the equivocal and ambiguous release of April 12 which the SEC and the plaintiffs in *Mitchell* contended to be materially false and misleading. In denying this charge, TGS argued, among other things, that as of April 12 its factual data were incomplete and insufficiently verified, that the release fairly reflected the facts as it knew them on that date, that the release was published in good faith to warn the investing public of the overly optimistic rumors which had been circulated and that the plaintiffs failed to demonstrate that TGS had derived any benefit therefrom.

It was in this factual context that Judge Waterman, writing the majority opinion for the Second Circuit, articulated the standard quoted in Respondent's Brief in Opposition, restated below to include the prefatory rationale here pertinent.

> "***The requirement that a statement may not be found misleading unless its issuance is actuated by a 'wrongful purpose' might well have the effect of permitting the issuers of misleading statements to seek an advantage but to escape liability if the advantage fails to materialize to the degree contemplated, or cannot be demonstrated.
>
> "More important, however, is the realization which we must again underscore at the risk of repetition, that the investing public is hurt by exposure to false or deceptive statements irrespective of the purpose underlying their issuance. *It does not appear to be unfair to impose upon corporate management a duty to*

ascertain the truth of any statements the corporation releases to its shareholders or to the investing public at large. Accordingly, we hold that Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media, *Fleischer, supra,* 51 Va. L.Rev. at 1294-95, if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes. It seems clear, however, that if corporate management demonstrates that it was diligent in ascertaining that the information it published was the whole truth and that such diligently obtained information was disseminated in good faith, Rule 10b-5 would not have been violated." *Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra,* at 861-862. (Emphasis supplied.)

The standard of full disclosure and the affirmative defense of due diligence were with reference to the incomplete and misleading press release of April 12, and it was with reference to the same release that the Tenth Circuit in *Mitchell* fashioned its "ripe for publication" language. In that factual context, the Tenth Circuit stated:

"The duty evolving upon a company facing these circumstances is to speak truthfully, accruately, and with total candor as to the material facts. That is not too much to ask of any company with the interest of its shareholders central to its commentary. It is what the SEC demands, what the law requires, and what every stockholder is entitled to. *Sunray DX Oil Company v. Helmerich & Payne, Inc.,* 398 F.2d 447 (10th Cir. 1968), does not forbid this reasoning. In the context of the facts there present, the court felt that a detailed statement would not add to the informed status of investors, but would mislead them due to the nuances

of technical terms used in divulging further information. The problems extant in that off-shore drilling case are not present in the instant controversy.

"It is said that if the courts require factual data in statements such as that originally framed by TGS, issuance of statements will fall out of favor and use. The conjecture is that by requiring a complete statement of material facts, corporations will cease to issue them and the Act will be frustrated in its attempt to keep stockholders informed of material facts. We view this speculation untenable, *for the duty to disclose facts when they become material has not been altered by this decision.* Simply stated, when the material information is available and ripe for publication, the difficulties inherent in formulating a release overbear the accuracy of the statements contained therein. Nor is it reasonable to conclude that the detail of a full release will preclude its publication in these circumstances. Indeed, the thoroughness of the April 16 release stands as evidence to the contrary." *Mitchell v. Texas Gulf Sulphur Co., supra,* at 100. (Emphasis supplied.)

In both these TGS cases, the respective Courts of Appeal held that the April 12 release was deceptive and misleading because it failed to state the material facts known to TGS at that time, notwithstanding TGS' argument that the core drilling and assays thereof had not been completed and verified.

In the instant case, the trial court applied this same standard which was applied by both the Second Circuit and the Tenth Circuit in the TGS cases and rejected the contention of Douglas which was similar to that of TGS. In his opinion denying motions for judgment notwithstanding the verdict, Judge Doyle stated:

"The defendants take the position that since their officers did not come face to face with actual verified numbers, that they cannot be held responsible for withholding information. *However, this is not and should not be the test of actual knowledge.* The question is whether the circumstances were sufficient so that the trier of the facts could justifiably determine that they, and hence the respective companies, were aware of the true conditions. ****Both Douglas and Merrill Lynch were aware from the evidence which was presented that the problems of Douglas were severe and that the earnings picture was fast deteriorating and that when this became public, the Douglas shares would decline substantially.**** *The initial optimistic reports and the withholding of the bad news violated the duty owed by both defendants.*****" Petition pp. 32a-33a. (Emphasis supplied.)

Validation of these statements of the trial judge does not require a review of all of the favorable reports and predictions which persisted through May 3, 1966, when 98% of Douglas' outstanding debentures had been converted into common stock. Respondent points to the fact that it thereafter published "bearish" information which adequately informed the investing public of a deteriorating earnings situation. What was this "bearish" information? First, a registration statement and preliminary prospectus dated June 7, 1966, disclosing that earnings for the five months ended April 30 were substantially the same as earnings for the three months ended February 28; and second, a release published in the Wall Street Journal on June 2, 1966, stating that it expected a few weeks' delay in making deliveries of some eighteen commercial jet airliners and that such delays would adversely affect its earnings in the current fiscal year ending November 30 by pushing some deliveries scheduled for fiscal 1966 into fiscal 1967 instead. (Brief in Opposition, p. 10). There was ample evidence from which the jury could conclude, and did conclude, that this was not a candid and complete disclosure of the material facts

known to Douglas at that time. There was evidence that Douglas was aware of an undercosting problem with the DC9 program early in April, and that a $1 million write-off which should have been reflected in the regular quarterly earnings statement for the fiscal quarter ended February 28, was not reflected in that quarterly statement, nor was it reflected in the special earnings report for the five months ended April 30, which appeared in the June 7 preliminary prospectus (R. Vol. IV, pp. 471-474). In the light of these facts it is accounting legerdemain to hold that the earnings through April were accurate and that the entire loss resulting from the ultimate verification and acknowledgment on June 24 of a $3.7 million write-off was incurred in the month of May.

The president of Douglas testified that as a result of "numbers" brought to him on May 27 he directed a task force of "50 or 75 people" to carefully review the facts in the aircraft division (R.Vol. II, p.p. 272-274) and that between June 14 and June 23 he remembered specifically three earnings figures for the six-months ended May 31. These figures were 14 cents, 49 cents, and 12 cents per share (R.Vol. VI, p. 906), all of which were materially less than the 85 cents per share for the five-months ended April 30 published in the June 7 preliminary prospectus.

Contrary to respondent's assertion, the accommodation of "non-hindsight" and "business judgment" policies was not similarly achieved by the Second Circuit's decision in *Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra,* and by the Tenth Circuit in this case.

The "business judgment" rule is inapplicable to this case. Petitioner at no time asserted any claim against the individual officers or directors of respondent. The Tenth Circuit acknowl-

edged that the rule was not directly applicable but stated that "the reasons for it are considered as extended to the corporate entity.[2]

The reasons were discussed by the Second Circuit in the TGS case, but the rule was inapplicable because TGS had accomplished its business purpose—the acquisition of property surrounding the drill site—prior to the issuance of its misleading release of April 12. In this case, respondent did not show any business purpose for withholding material information or for the publishing of materially deficient reports and half-truths.

"Hindsight" was not mentioned by the Second Circuit in the TGS case. In this case, the Tenth Circuit stated:

> "The silence or the timing are matters which require the court *or the jury* to examine how these decisions were arrived at by using many subjective factors and by excluding hindsight." Petition p. 45a. (Emphasis supplied.)

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[2]In amplification of this statement, the opinion continues: "The Second Circuit in Securities & Exchange Comm'n. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir.), said in a footnote that the *timing* of the disclosure of material facts '. . . is a matter for the business judgment of the corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC.' The court there held *a valid corporate purpose was served by withholding information from the public on the discovery of ore in a test drilling,* thus a matter within the 'business judgment' of management. Thus considering the factors compelled to be evaluated in this silence case as revealed in the record before us, we must hold that the decision of the officers or directors, and the corporation decision of the defendant to issue an earnings statement on other than the customary date for such statements, and the timing of such statement was a matter of discretion." Petition, p. 47a. (Emphasis supplied.)

The jury had before it many facts relevant to management's decisions and course of conduct, on the basis of which it could evaluate the subjective factors without hindsight. It did not require 20-20 foresight to foresee that the material facts known to respondent and undisclosed to the public at and for many weeks prior to the time of petitioner's purchases would have, when disclosed, a severe impact on the price of Douglas stock.

Petitioner contends, with respect to an issuer corporation's duty to disclose material facts to public investors, that the standard applied by the trial judge to the facts of this case was correct and in conformity with the standards applied by the Second Circuit and Tenth Circuit in the TGS cases above cited and by this Court in the cases cited in the petition. That standard imposes a duty on a corporate issuer of securities traded in national security markets to disclose candidly and completely all of the facts as soon as they become material. Such standard should apply *a fortiori,* where the issuer previously has caused or knowingly permitted to be circulated materially different facts and forecasts.

The standard applied by the Tenth Circuit in the factual context of this case disregards the preceding acts and practices which have influenced the markets and emasculates the materiality test by the inclusion of a purely unilateral element—i.e., that there is no duty to disclose material facts until such material facts can be presented in form and detail satisfactory to the issuer's management.

Petitioner submits that such a standard subverts the philosophy of full disclosure and the maintenance of fair and honest markets.

Respondent's assertion that the petitioner has been rebuffed on certain theories is distorted and unwarranted, being

without adequate explanation as to the parties involved and the development of the issues at different stages in the protracted proceedings below. In any event, the argument that petitioner should not be allowed to change "theories" is untenable. There is nothing in 10b-5 jurisprudence which restricts a litigant to a non-disclosure theory or any other specific theory. Under the public policy declarations of this Court, petitioner may invoke the full panoply of Rule 10b-5.

II. *Public Investors Trading in National Security Markets Are Entitled to Rely on the Integrity of Those Markets and Reliance Upon Prevailing Market Prices Does Not Amount to a Lack of Due Diligence.*

Petitioner contends that its reliance and due diligence were established in accordance with standards established by this Court, as set forth in its petition at pages 16-18. In assailing this contention, respondent has lost sight of the dominant consideration involved in this case—the maintenance of fair and honest markets in securities transactions. In its brief in opposition (pp. 10-11), respondent calls attention to "bearish" information in petitioner's own files including a tabulation of broker's reports establishing a downward trend of earnings and argues "when a professional investor ignores public information and data in its own files or fails to carry through its own investigation, it should be barred from recovery."

Respondent ignores the fact that the same information was known to hundreds of investors trading on national security markets, and the market price of Douglas stock reflected their collective evaluation of such information. Respondent's argument necessarily implies that a "professional" investor who relies on the assumption that he is trading in a fair and fully informed market is not a "reasonable" investor. Profes-

sional investors, like all others, are entitled to candid disclosure of material facts.[3]

Respondent's faulting of petitioner for failing to contact Douglas or Merrill Lynch before making its purchase is unrealistic and baseless. Petitioner was informed by the June 7 preliminary prospectus that earnings for the five months ended April 30 were 85 cents per share. Surely, it was not incumbent on petitioner or any other public investor to contact Douglas or Merrill Lynch to ascertain whether anything was happening which would reduce these earnings to 12 cents per share for the first six months. Moreover, it would have been unlawful for Douglas or Merrill Lynch to have given petitioner any information which it did not give to the entire investing public.

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[3]In *Stier v. Smith*, 473 F.2d 1205, 1207 (5th Cir. 1973), the court stated: "***The sins of the Defendant against Rule 10b-5 which are before the Court on appeal are ones of omission rather than commission. The trial Judge specifically found that there were 14 facts which the Defendant failed to disclose to the Plaintiff. However, in view of the sophistication and financial acumen of the Plaintiff, his knowledge of the fact that a registration statement had been filed and a prospectus was available upon his request, and his failure to look further into the matter all led the trial court to conclude that Defendant was not in violation of 10b-5.

"We choose not to take issue with the finding that Appellant was a sophisticated investor. We hold that Appellant was entitled to judgment as a matter of law because sophisticated investors, like all others, are entitled to the truth."

CONCLUSION

The issues involved and the legal standards to be applied in the factual context of this case are of national importance and of vital concern to issuer corporations and the investing public. These issues merit the attention and decision of this Court. The writ should be granted.

Respectfully submitted,

Leland E. Modesitt
1900 Security Life Building
Denver, Colorado 80202
COUNSEL OF RECORD FOR PETITIONER

OF COUNSEL:

Richard H. Shaw
1500 United Bank Center
Denver, Colorado 80202

John J. King, Jr.
Gorsuch, Kirgis, Campbell, Walker and Grover
1900 Security Life Building
Denver, Colorado 80202